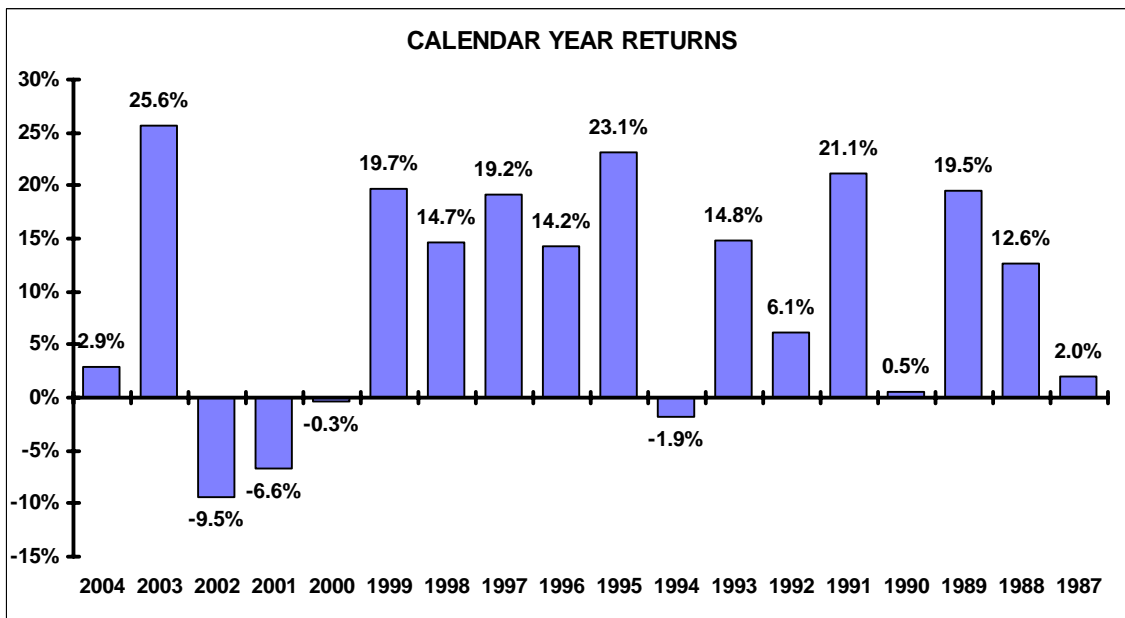
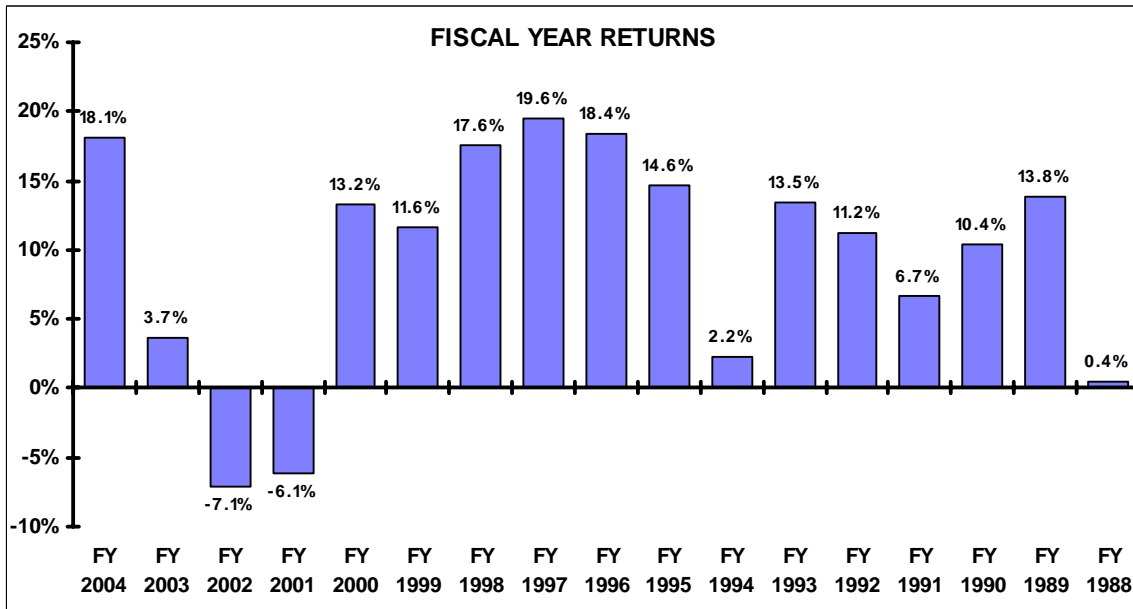


## REPORT ON INVESTMENT ACTIVITY

Prepared by Robert M. Maynard, Chief Investment Officer

PERSI had a very good, and in many ways spectacular, fiscal and calendar year. The 2004 fiscal year return of 18.1% was on par with the boom year returns of 1995-2000. The 2003 calendar year return of 25.6% was the best calendar year return in PERSI's history (since 1966). PERSI's peer performance rankings rebounded strongly as well, ranking as high as in the top 5% of public funds in the nation for some periods and well above median for almost all time periods.



The return percentage for calendar year 2004 is for the period ending June 30, 2004.



## RANKINGS IN THE CALLAN PUBLIC FUND UNIVERSE

March 31, 2004

Percentile Rankings over Period  
(1 is highest, 100 is lowest)

|                   | QTR | 1Yr  | 2Yrs | 3Yrs | 4Yrs | 5Yrs | 7Yrs | 10Yrs |
|-------------------|-----|------|------|------|------|------|------|-------|
| Return (%)        | 3.6 | 33.6 | 8.0  | 5.6  | 1.4  | 5.2  | 8.6  | 9.8   |
| Peer Rank         | 5   | 5    | 15   | 42   | 69   | 36   | 27   | 31    |
| Median Return (%) | 2.8 | 26.8 | 6.9  | 5.5  | 2.2  | 4.9  | 8.1  | 9.5   |

Perhaps even more impressively, PERSI outperformed the market by a wide margin for both the past year and the past five years, through the worst market environment for an equity oriented fund since the Great Depression. Over the past year, market returns would have given PERSI a 15.3% return, instead, PERSI garnered a return of 18.1%. Over the past five years, simply matching the market would have given PERSI an annualized return of 1.5%, instead PERSI over doubled that return to 3.9%. In dollars, PERSI should have expected to make around \$420 million over the past five years, instead, PERSI added over \$1.25 billion in returns – an outperformance of around \$850 million. Simply, the reason was that over the past year, and also over the past five years, all of PERSI's major "bets" (global management, REITS – Real Estate Investment Trust Securities, emerging markets, TIPS – Treasury Inflation Protected Securities, etc.), have worked and, collectively, PERSI's active managers have beaten their benchmarks.

This added return drove PERSI's peer performance as well, raising PERSI from what would otherwise have been a generally below median fund to a top performing fund. For the period ending March 31<sup>st</sup>, for example, the results were as follows for cumulative time periods:

|                   | QTR | 1Yr  | 2Yrs | 3Yrs | 4Yrs | 5Yrs | 7Yrs | 10Yrs |
|-------------------|-----|------|------|------|------|------|------|-------|
| Actual Return (%) | 3.6 | 33.6 | 8.0  | 5.6  | 1.4  | 5.2  | 8.6  | 9.8   |
| Peer Rank         | 5   | 5    | 15   | 42   | 69   | 36   | 27   | 31    |
| Policy Return (%) | 2.9 | 31.0 | 6.3  | 5.0  | -0.3 | 3.0  | 7.8  | 9.6   |
| Policy Rank       | 27  | 16   | 66   | 64   | 95   | 96   | 61   | 40    |

Consequently, despite a strategic policy that would have meant poor performance for PERSI over 2 to 7 years, both absolutely and relatively (as would be expected given the horrible equity markets of 2000-2003), PERSI has come through what should have been very rough waters with remarkable serenity.

In fact, the concern at the moment is that the current stretch of performance may represent a peak, and could be a limit on how good PERSI can be. PERSI is not structured to be a consistent outstanding performer – instead, we are structured to be a median to slightly above median fund. We are set up to hit singles, not home runs. The exceptional stretch of absolute and relative performance may be due to a confluence of luck when most of our particular biases or special leanings all happened to perform well together. Most of those leanings are undertaken for diversification or other reasons (global equity, TIPS, Idaho Mortgages, REITS, etc.), not for "juicing up" our returns. We rely primarily on the markets, not special efforts, for our returns. The exceptional performance of those special efforts, almost all at the same time, is likely to be an occasion that will not be consistently repeated. The softening of performance in the fourth quarter of the fiscal year may represent a "return to normality." Nonetheless, it is nice to know that there can be some market circumstances, like the last year and collectively over the past five years, where all the stars can be lined up at once.

It was also a year of significant structural change for the first time in a number of years. After the retirement of its long-time general consultant, Doug Dorn, PERSI hired Michael O'Leary and Janet Becker-Wold of Callan Associates to serve in that role. And, after firing Schroders (both emerging markets and EAFE mandates), Deutsche Asset Management, and MFS, PERSI hired, at the end of the year, Donald Smith and TCW for domestic equity mandates, Delaware Asset Management for international equities, and Bernstein for both a global equity mandate and an international equity mandate.



Almost all parts of PERSI's investment program had stellar annual and longer-term performance, either absolutely, relative to the markets, or, mostly, both. The best performing parts of the PERSI portfolio were the emerging markets, international equities, and the global equity segments, with annual returns of 36.9% (led by Genesis with returns of 38.9%), 30.9% (led by the Mellon Index Fund, with returns of 31.5%), and 27.3% (led by Brandes, with returns of 38%). The worst PERSI return came from its "safest" investments – the investment grade government and corporate bond index fund, with a loss of -0.7%, and the Idaho Mortgage program, with a loss of -2.3% (the fixed income portfolio as a whole gained 1.4% paced, once again, by the TIPS portfolio with returns of 4.2%).

PERSI's US equity segment returned 21.8%, compared to the general US market return (the Russell 3000) of 19.6%. This was primarily due to the high returns of the REIT portfolio managed by Lend Lease, with returns of 33.6%, beating both the general equity market and the overall REIT market return of 27.7%. Tukman and Mountain Pacific both had good absolute returns of 14.6% and 27.3% respectively, although each lagged their respective benchmarks significantly. The Mountain Pacific return, while behind the small cap benchmark of 32.9%, beat the general overall equity market, thus actually helping PERSI's overall portfolio because of the relatively higher amount given to that manager. Private equity had its first positive return of around 20.8% (time weighted), and private equity real estate returned 7.8%, ahead of the general private real estate market, but behind the Russell 3000.

Global equity managers again had an excellent year, although softening a bit in the final quarter. Overall returns for the segment of 27.3% beat the world equity market returns of 23.6%. Brandes once again led the pack with returns of 38%, followed by Cap Guardian at 26.3%. Barings slightly lagged the index with a 23% return, while Zesiger had its first poor year with overall returns of 18%, due to a collapse in the fourth quarter from its emerging market exposure, and, over the entire fiscal year, from exposures to private equity.

The international equity segment benefited from the dedicated exposure to emerging markets. Overall, the total international equity segment underperformed EAFE, with returns of 30.9% compared to the index return of 31.6%. This would even have been worse without emerging markets, which returned 36.9% for the year, with Genesis (our remaining emerging markets manager from last year) returning 38.9%. Our active managers all underperformed the EAFE index, with TCW International (SGAM) returning 30.9%, Rowe Price at 25.3%, and Schrodgers also lagging prior to their termination in April.

Fixed income had another excellent year in comparison with the general fixed income market, although the bond market as a whole had its worst year in quite a while. PERSI's fixed income total return of 1.4% handily beat (in fixed income terms) the general US investment grade market, which had one of its rare flat years with a return of 0.5%. Once again, PERSI's large commitment to TIPS drove this relative outperformance, with a return of 4.2%. Clearwater MBS had a good year, with returns of 3.4%, and Barings fixed income also significantly outperformed, with a return of 2.5%. DBF underperformed the mortgage index with returns of 1.1%, while Idaho Mortgages trailed the pack with one of its worst years ever with a return of -2.3%.

The consistent and significant outperformance of PERSI over the market over the last five years answered, in a positive manner, one of the major concerns in the past: as we commented in the 2001 annual report following the booming markets of the late 1990s,

The unanswered question was whether the higher-than-expected returns [that PERSI had enjoyed in the late 1990s] were being achieved because of incurring higher-than-expected-risk – that the price to be paid for such good performance was greater-than-market loss when times were bad.

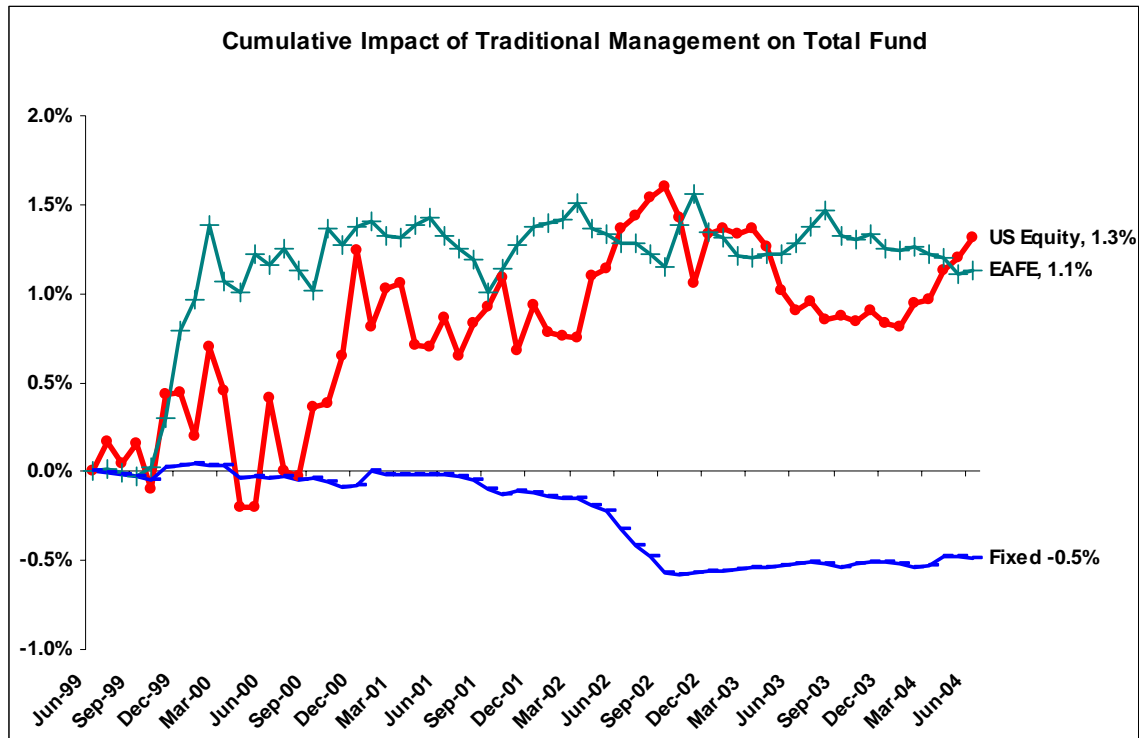
What actually transpired is that, compared to the general market returns, and contrary to our fears, PERSI did even better in poor markets than it had when times were good. Over the past five years, PERSI has outperformed general market returns by around 13%, adding over \$850 million over market returns. Since simple market returns (55% US equities, 15% international equities, and 30% US bonds) would only have given a 7.6% cumulative return, or around \$420 million, PERSI effectively almost tripled its return by the decisions of the Board and active managers over the past five years.

And, it was Board decisions that provided the bulk of the added return. One way of looking at PERSI actions is to begin with the strategic long-term allocation of 55% US equities, 15% international equities, and 30% fixed income. PERSI could simply index all of its assets by placing its money in three index funds (a Russell 3000 US equity index fund, an EAFE international



index fund, and a Lehman Aggregate US bond fund), and “go home”, simply rebalancing the funds to those allocations at the beginning of every month.

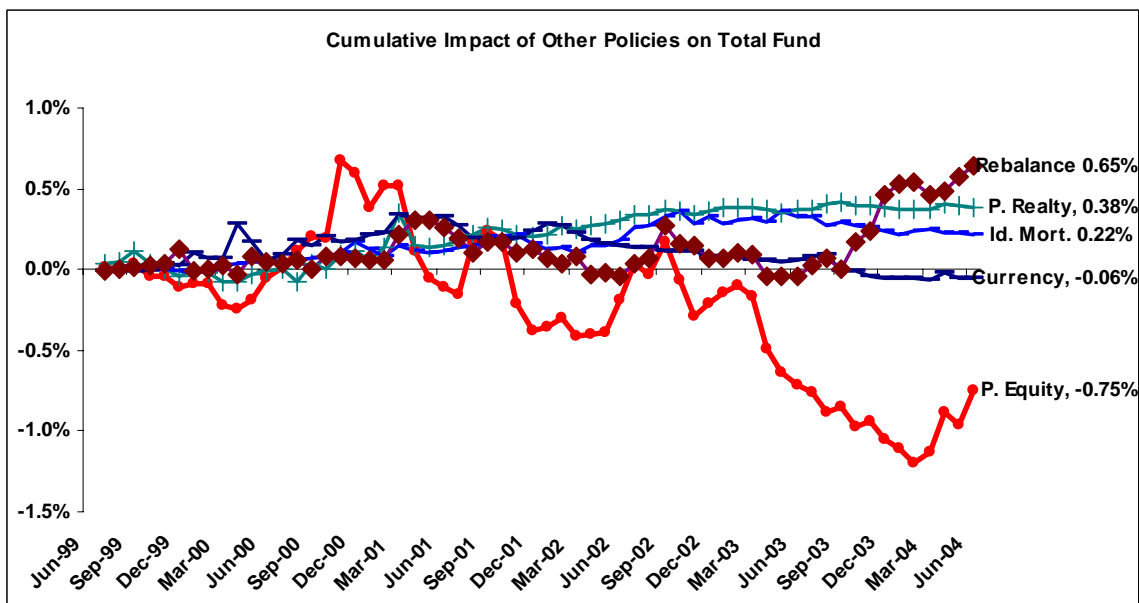
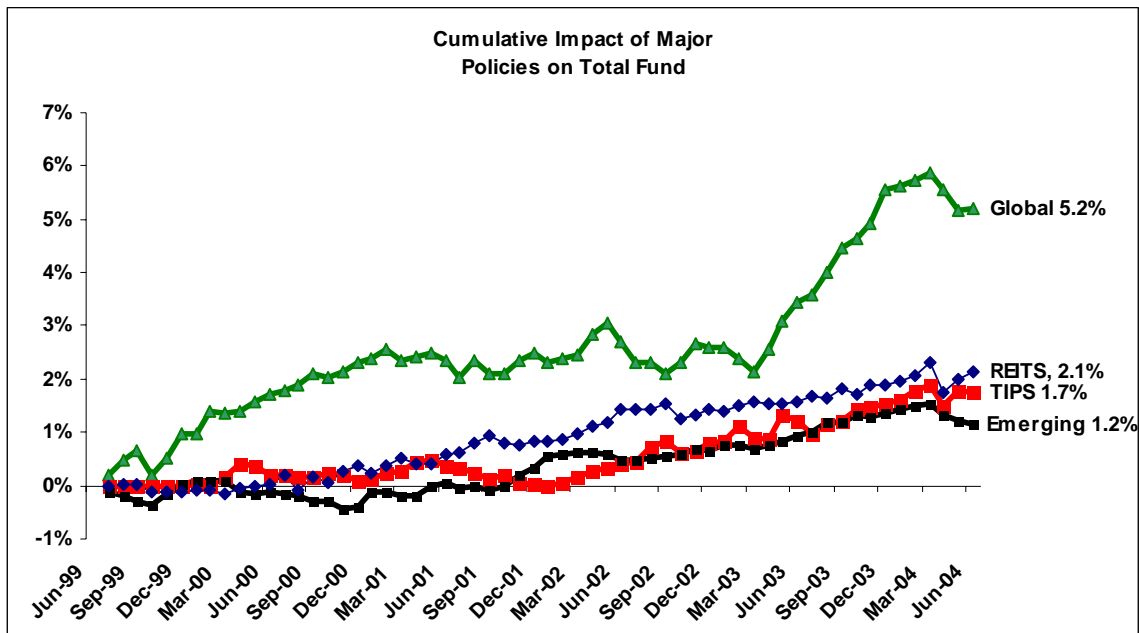
Instead, PERSI has taken a number of actions that make its actual returns different than simple market returns. One class of actions is by hiring active managers in the general US and international equity and US fixed income markets --- this is the “traditional” active manager activity. Over the past year this added only a very small amount to PERSI returns – around 0.1%, and over the past five years traditional active management has cumulatively done a bit better – adding around 0.3% per year or 2.3% cumulatively. US equity managers have added 1.3% cumulative to total fund returns over the past five years, international equity managers have added 1.1% over that time period, and fixed income activities outside of TIPS and Idaho Mortgages have lost 0.5% over that five year period.



But a much greater impact has come from actions at the Board level. These are actions that have diversified the portfolio out of the strict investments of assets in the usual manner within the general capital markets (US public equity, international developed market public equity, and US investment grade fixed income). Collectively, these actions have added 2.5% to PERSI returns over the past year, and 2% per year over the past 5 years, or 10.1% cumulatively. These actions are as follows (the numbers in parenthesis are the cumulative additional return to the total fund returns from these activities over the past five years):

1. Using global equity managers instead of US equity managers (5.2%);
2. Investing in US real estate assets, both public (2.1%) and private (0.4%);
3. Holding interests in private equity partnerships rather than US public equities (-0.75%);
4. Investing in emerging markets rather than simply developed international markets (1.2%);
5. Hedging a portion of the international equity currency exposure (-0.06%);
6. Investing in TIPS (Treasury Inflation Protected Securities) instead of the traditional US bond market (1.7%)
7. Holding direct private Idaho commercial mortgages instead of US bond assets (0.22%)
8. Rebalancing at intervals instead of strictly at the beginning of every month (0.65%).





Given the exceptional performance, and the likelihood that the circumstances driving that performance might not continue, a major question is whether PERSI should change course from its current path. This may particularly be the case since many believe that the next decade will be more problematic for markets. This is a view I share, but not to the degree of pessimism often heard. There has been a “tailwind” of a decades-long decline in interest rates that has now ended, and this decline in the past led to an extra support of the equity markets that is now over. While the next decade is likely to still be “normal” (meaning a real return on equities in the 6%-6.5% range, and a real return on bonds in the 2% - 2.5% range), the absence of the extra support from declining interest rates means potentially more difficulty over the intermediate and longer term.

Nonetheless, the cushion that is available to the Board from the ability to not grant discretionary COLAs along with some flexibility in contribution rates allows PERSI adequate leeway to continue the basic investment policies currently followed.



These policies are:

1. That we will invest in an attempt to pay discretionary COLAs, while recognizing that this added benefit will be the first to go if difficult investment markets occur;
2. This investment policy means that we will maintain a general 70% equity, 30% fixed income stance – sufficient to generate around a 5%-5.4% “real” return and therefore give a reasonable chance of paying the discretionary COLA;
3. We will rely on general markets to provide the needed returns, and not count on above market returns through active management or other sources. While we will pursue active management and additional sources of return, these efforts will be weighed against the problems of additional complexity and headline risk, and are there to provide a cushion or “insurance”. We will not pursue an aggressive return model employed by many endowment funds or other similarly focused institutions;
4. If markets get difficult, we will rely first on our other alternatives rather than pursue significantly more aggressive investment postures (materially more equity exposure, aggressive or complicated return strategies such as hedge funds or absolute return, or numerous small strategies, such as extensive cash enhancement, in-house active management, etc.).

All of our investment policies and structure follow logically and directly from these four points – mostly in a single step. These policies and structures have survived well all of the “stress tests” of the past ten years, and has, over the years, outperformed the market in both up and down cycles. The remaining type of market – the prolonged sideways market – still needs to be tested. That is the probable challenge of the upcoming years.

Thus, given the likely more problematic but generally “normal” nature of the markets over the next ten years, the general portfolio theme that PERSI will provisionally pursue over the next few years is that we will generally “stay the course” set over the past decade, but play a bit harder around the edges of the portfolio. Specifically, this means that PERSI will pursue a bit more active management both publicly and privately, maintain a slight tilt towards value and GARP strategies, and will continue to investigate potential new portfolio areas, like the past entries into global equity, TIPS, REITS, and emerging markets (although no new prospects are currently promising). These will be, however, leanings, and not radical new directions for the portfolio.

For the numbers presented, the source of the above-disclosed data is the Mellon Trust Services reporting system, which follows AIMR’s Performance Presentation Standards.



# Investment Summary as of the Year Ended June 30, 2004

| <u>Types of Investment</u>            | <u>Market Value</u>    | <u>Percent of Total Market Value</u> |
|---------------------------------------|------------------------|--------------------------------------|
| <b>Short-term Investments</b>         | \$277,708,503          | 3.6%                                 |
| <b>Fixed Income</b>                   |                        |                                      |
| Domestic                              | 1,840,801,941          | 23.9%                                |
| International                         | 59,889,873             | 0.8%                                 |
| Commercial Mortgages                  | 259,763,230            | 3.4%                                 |
| <b>Total Fixed Income</b>             | 2,160,455,044          | 28.1%                                |
| <b>Common Stock</b>                   |                        |                                      |
| Domestic Equity                       | 3,383,417,417          | 43.8%                                |
| International Equity                  | 1,657,691,373          | 21.5%                                |
| <b>Total Common Stock</b>             | 5,041,108,790          | 65.5%                                |
| <b>Private Equity</b>                 | 163,073,839            | 2.1%                                 |
| <b>Real Estate</b>                    | 59,687,610             | 0.8%                                 |
| <b>Total Base Plan Investments</b>    | <u>\$7,702,033,786</u> | <u>100.0%</u>                        |
| <b>Other Funds:</b>                   |                        |                                      |
| Sick Leave Insurance Reserve Fund     | 163,689,994            |                                      |
| Choice Plan 414(k)                    | 53,977,831             |                                      |
| Choice Plan 401(k)                    | 84,731,711             |                                      |
| <b>Total Investments in All Funds</b> | <u>\$8,004,433,322</u> |                                      |



## Schedule of Investments by Account (including interest and dividends receivable) as of June 30, 2004

|   |                        |
|---|------------------------|
| Apollo Management, LP   | \$8,111,968            |
| Baring Asset Management-Global Equity   | 228,233,310            |
| Baring Asset Management-Global Fixed Income                                     | 247,061,632            |
| Bernstein-Emerging Markets  | 112,327,916            |
| Bernstein-Global Equity   | 153,322,841            |
| Brandes Investment Partners   | 408,190,600            |
| Capital Guardian  | 240,124,165            |
| Chisholm Management, LP   | 17,080,932             |
| Choice Plan Investment Options (excluding Total Return Fund)                    | 31,070,900             |
| Clearwater Advisors, LLC  | 69,462,110             |
| D.B. Fitzpatrick & Co.-Idaho Mortgages  | 264,719,011            |
| D.B. Fitzpatrick & Co.-Fixed Income   | 208,147,770            |
| Delaware International Advisers   | 154,502,838            |
| Donald Smith & Co.  | 157,664,935            |
| Frazier Technology Ventures II, LP  | 2,107,500              |
| Furman Selz Investments, LP   | 16,096,744             |
| Galen Associates, LP  | 34,569,438             |
| Genesis Asset Managers  | 141,302,196            |
| Goense Bounds & Partners, LP  | 1,621,206              |
| Gores Capital Partners, LLP   | 3,905,198              |
| Green Equity Investors IV, LP   | 2,540,365              |
| Harvest Partners III, LP  | 13,487,023             |
| Highway 12 Ventures, LP   | 3,181,468              |
| Ida-West  | 3,275,000              |
| Koll Partners, LLP  | 15,762,370             |
| Lend Lease Rosen  | 229,344,247            |
| Littlejohn, LP  | 7,255,364              |
| McCown DeLeeuw & Co. IV, LP   | 8,254,546              |
| Mellon Capital Management-R2000 Small Cap                                       | 142,053,680            |
| Mellon Capital Management-S&P 500 Large Cap                                     | 1,353,423,387          |
| Mellon Capital Management-Mid Cap Completion                                    | 197,840,689            |
| Mellon Capital Management-International Stock Index                             | 359,885,114            |
| Mellon Transition Management Services   | 624,243                |
| Mountain Pacific Investment Advisors  | 266,643,279            |
| Oaktree Capital Management, LLC   | 9,723,170              |
| Pareto Partners   | 131,560                |
| PERSI Cash in Short-Term Investment Pool  | 17,338,811             |
| Providence Equity Partners, LLP   | 16,081,488             |
| Prudential Investments  | 35,049,076             |
| Rowe Price International  | 209,141,688            |
| Saugatuck Capital Company   | 1,054,556              |
| State Street Global Advisors-Fixed Income                                       | 760,715,492            |
| State Street Global Advisors-TIPS   | 678,429,125            |
| State Street Global Advisors-Sick Leave Insurance Reserve                       | 163,689,994            |
| T3 Partners, LP   | 15,764,139             |
| TCW Domestic  | 153,458,508            |
| TCW London International  | 210,103,309            |
| Thomas Lee, LP  | 10,761,484             |
| Tukman Capital Management   | 253,566,546            |
| W. Capital Partners, LP   | 1,355,456              |
| Zesiger Capital Group   | 262,403,175            |
| Zesiger Capital Group-Private Equity  | 19,062,303             |
| <hr/>   |                        |
| Total Market Value, Including Investment Receivables and Payables               | \$7,921,023,865        |
| Add: Investments Purchased  | 829,687,740            |
| Less: Investments Sold  | (712,838,249)          |
| Less: Interest and Dividends Receivable (Base Plan, FRF, and Total Return Fund) | (33,440,034)           |
| <hr/>   |                        |
| Total Market Value, Net of Investment Receivables and Payables                  | <u>\$8,004,433,322</u> |



**Investment Results (Defined Benefit Plans Only)**

| MANAGERS                               | TOTAL                 | % OF          | Investment Performance for Periods Ending |        |         |         |
|--|-----------------------|---------------|---|--------|---------|---------|
|  | MKT VAL<br>(MILLIONS) | TOTAL<br>FUND | FISCAL                                    | 1 YR   | 3 YRS * | 5 YRS * |
| U.S. EQUITY                            |                       |               |   |        |         |         |
| MELLON CAPITAL MANAGEMENT MID CAP      | \$197.8               | 2.6           | 25.9                                      | 25.9   | 2.3     | 0.4     |
| MELLON CAPITAL MANAGEMENT R2000 SM CAP | 142.1                 | 1.8           | 32.4                                      | 32.4   | 6.4     |         |
| MELLON CAPITAL MANAGEMENT S&P 500 LC   | 1,353.4               | 17.5          | 18.9                                      | 18.9   | (0.7)   | (2.1)   |
| MOUNTAIN PACIFIC                       | 266.6                 | 3.5           | 27.1                                      | 27.1   | 7.6     | 7.7     |
| TUKMAN CAPITAL MGMT                    | 253.6                 | 3.3           | 14.5                                      | 14.5   | 2.2     | 3.4     |
| DONALD SMITH**                         | 157.7                 | 2.0           |   |        |         |         |
| TCW**                                  | 153.5                 | 2.0           |   |        |         |         |
| TOTAL U.S. PUBLICLY TRADED EQUITY      | \$2,524.7             | 32.7          | 20.7                                      | 20.7   | 0.1     | (0.4)   |
| BENCHMARK – Russell 3000               |                       |               | 20.5                                      | 20.5   | 0.2     | (1.1)   |
| PRIVATE EQUITY                         |                       |               |   |        |         |         |
| SAUGATUCK-VNTR CAP                     | \$1.1                 | 0.0           | 12.6                                      | 12.6   | (3.1)   | (8.0)   |
| IDA-WEST                               | 3.3                   | 0.1           | 66.8                                      | 66.8   | 32.1    | 21.5    |
| GALEN III                              | 34.6                  | 0.4           | 26.0                                      | 26.0   | 8.4     | 4.2     |
| FURMAN SELZ                            | 16.1                  | 0.2           | 101.5                                     | 101.5  | 19.9    | 14.1    |
| HARVEST PARTNERS                       | 13.5                  | 0.2           | (15.5)                                    | (15.5) | (6.7)   | (3.8)   |
| MCCOWN DE LEEUW                        | 8.3                   | 0.1           | (3.6)                                     | (3.6)  | (7.5)   | (15.0)  |
| PROVIDENCE EQ PARTNERS                 | 16.1                  | 0.2           | 163.3                                     | 163.3  | 10.7    | 10.3    |
| CHISOLM PARTNERS IV L.P.               | 17.1                  | 0.2           | (7.3)                                     | (7.3)  | (24.9)  | (9.3)   |
| LITTLEJOHN II L.P.                     | 7.3                   | 0.1           | (6.0)                                     | (6.0)  | (16.0)  |         |
| OAKTREE CAP                            | 9.7                   | 0.1           | 43.2                                      | 43.2   | 8.6     |         |
| GOENSE BOUNDS                          | 1.6                   | 0.0           | 395.8                                     | 395.8  | 63.7    |         |
| ZESIGER                                | 19.1                  | 0.3           | 5.0                                       | 5.0    | (19.4)  |         |
| HIGHWAY 12 FD VENTURE L.P.             | 3.2                   | 0.1           | (9.4)                                     | (9.4)  |         |         |
| T3 PARTNERS II L.P.                    | 15.8                  | 0.2           | (5.1)                                     | (5.1)  |         |         |
| APOLLO MGMT L.P.                       | 8.1                   | 0.1           | 53.5                                      | 53.5   |         |         |
| THOMAS LEE L.P.                        | 10.8                  | 0.1           | 13.7                                      | 13.7   |         |         |
| GREEN EQUITY IV L.P. **                | 2.5                   | 0.0           |   |        |         |         |
| GORES CAP AD LLC**                     | 3.9                   | 0.1           |   |        |         |         |
| W CAP PARTNERS**                       | 1.4                   | 0.0           |   |        |         |         |
| FRAZIER TECH VENTURES II**             | 2.1                   | 0.0           |   |        |         |         |
| TOTAL PRIVATE EQUITY                   | \$195.3               | 2.5           | 23.5                                      | 23.5   | (1.7)   | (2.9)   |
| REAL ESTATE                            |                       |               |   |        |         |         |
| KOLL PARTNERS**                        | \$15.8                | 0.2           |   |        |         |         |
| LEND LEASE - PUBLIC                    | 229.3                 | 3.0           | 32.9                                      | 32.9   | 19.1    | 17.7    |
| PRUDENTIAL                             | 35.0                  | 0.4           | 10.8                                      | 10.8   | 11.5    | 9.8     |
| TOTAL R/E MANAGERS                     | \$280.2               | 3.6           | 29.2                                      | 29.2   | 17.9    | 16.6    |
| BENCHMARK - NCREIF                     |                       |               | 10.8                                      | 10.8   | 8.0     | 9.4     |
| TOTAL U.S. EQUITY                      | \$3,000.1             | 38.8          | 21.7                                      | 21.7   | 1.2     | 0.5     |
| BENCHMARK – Russell 3000               |                       |               | 20.5                                      | 20.5   | 0.2     | (1.1)   |
| GLOBAL EQUITY                          |                       |               |   |        |         |         |
| BARING ASSET MANAGEMENT                | \$228.2               | 2.9           | 23.0                                      | 23.0   | 0.5     | (3.8)   |
| BRANDES INVST PARTNERS                 | 408.2                 | 5.3           | 38.0                                      | 38.0   | 8.3     | 10.6    |
| CAPITAL GUARDIAN                       | 240.1                 | 3.1           | 26.3                                      | 26.3   |         |         |
| ZESIGER CAPITAL GROUP                  | 262.4                 | 3.4           | 18.5                                      | 18.5   | 5.8     | 10.9    |
| BERNSTEIN**                            | 153.3                 | 2.0           |   |        |         |         |
| TOTAL GLOBAL EQUITY                    | \$1,292.3             | 16.7          | 27.0                                      | 27.0   | 4.2     | 5.2     |
| TOTAL U.S./GLOBAL EQUITY               | \$4,292.4             | 55.5          | 23.5                                      | 23.5   | 2.1     | 1.6     |
| BENCHMARK – Russell 3000               |                       |               | 20.5                                      | 20.5   | 0.2     | (1.1)   |

(Continued)



**Investment Results (Defined Benefit Plans only)**

| MANAGERS                                 | TOTAL<br>MKT VAL<br>(MILLIONS) | % OF<br>TOTAL<br>FUND | Investment Performance for Periods Ending |       |         |         |
|--|--------------------------------|-----------------------|---|-------|---------|---------|
|  |                                |                       | FISCAL                                    | 1 YR  | 3 YRS * | 5 YRS * |
| INTERNATIONAL EQUITY                     |                                |                       |   |       |         |         |
| GENESIS EMERGING                         | \$141.3                        | 1.8                   | 38.1                                      | 38.1  | 17.8    | 10.2    |
| MELLON CAPITAL MGMT INTL STK INDX        | 359.9                          | 4.7                   | 31.5                                      | 31.5  | 4.0     | 0.2     |
| T ROWE PRICE                             | 209.1                          | 2.7                   | 25.3                                      | 25.3  | 2.5     | 0.1     |
| SOCIETE GENERALE                         | 210.1                          | 2.7                   | 31.5                                      | 31.5  | 0.7     | 0.8     |
| BERNSTEIN EMG MKT**                      | 112.3                          | 1.5                   |   |       |         |         |
| DELAWARE**                               | 154.5                          | 2.0                   |   |       |         |         |
| TOTAL INTERNATIONAL EQUITY               | \$1,187.3                      | 15.4                  | 31.2                                      | 31.2  | 4.4     | 1.5     |
| TOTAL INT'L EQUITY (HEDGED) <sup>1</sup> | \$1,187.4                      | 15.4                  | 30.6                                      | 30.6  | 3.7     | 1.4     |
| BENCHMARK – EAFE Index Net               |                                |                       | 32.4                                      | 32.4  | 3.9     | 0.1     |
| TOTAL EQUITY                             | \$5,479.8                      | 70.9                  | 25.0                                      | 25.0  | 2.5     | 1.7     |
| BENCHMARK – Russell 3000                 |                                |                       | 20.5                                      | 20.5  | 0.2     | (1.1)   |
| U.S. FIXED INCOME                        |                                |                       |   |       |         |         |
| D.B. FITZPATRICK & CO                    | \$208.1                        | 2.7                   | 1.1                                       | 1.1   | 5.9     | 6.8     |
| D.B. FITZPATRICK & CO-IDAHO MTGS         | 264.7                          | 3.4                   | (2.4)                                     | (2.4) | 6.9     | 7.9     |
| STATE ST ADV                             | 760.7                          | 9.9                   | (0.7)                                     | (0.7) | 6.6     | 7.0     |
| STATE ST-TIPS                            | 678.4                          | 8.8                   | 4.2                                       | 4.2   | 10.0    |         |
| CLEARWATER-TBA                           | 69.5                           | 0.9                   | 3.4                                       | 3.4   |         |         |
| TOTAL U.S. FIXED INCOME                  | \$1,981.5                      | 25.7                  | 1.3                                       | 1.3   | 8.0     | 8.4     |
| GLOBAL FIXED INCOME                      |                                |                       |   |       |         |         |
| BARING ASSET MANAGEMENT                  | \$247.1                        | 3.2                   | 2.5                                       | 2.5   | 6.7     | 7.1     |
| TOTAL GLOBAL FIXED INCOME <sup>^</sup>   | \$247.1                        | 3.2                   | 2.5                                       | 2.5   | 4.8     | 6.0     |
| TOTAL FIXED INCOME                       | \$2,228.5                      | 28.9                  | 1.5                                       | 1.5   | 7.4     | 7.9     |
| BENCHMARK – LB Aggregate                 |                                |                       | 0.3                                       | 0.3   | 6.4     | 6.9     |
| OTHER                                    |                                |                       |   |       |         |         |
| UNALLOCATED CASH                         | \$17.3                         | 0.2                   | 2.9                                       | 2.9   | 4.9     | 6.2     |
| MELLON TRANSITION MANAGEMENT SERVICES    | 0.6                            | 0.0                   |   |       |         |         |
| TOTAL OTHER                              | \$17.9                         | 0.2                   | 2.9                                       | 2.9   | 4.9     | 6.2     |
| COMBINED TOTAL                           | \$7,726.2                      | 100.0                 | 18.1                                      | 18.1  | 4.4     | 3.9     |
| BENCHMARK – 55% Russell 3000             |                                |                       | 15.9                                      | 15.9  | 3.2     | 2.1     |
| 30% Lehman Aggregate                     |                                |                       |   |       |         |         |
| 15% MSCI EAFE Index                      |                                |                       |   |       |         |         |
| Add: Mutual Fund Holdings in 401(K) Plan | \$31.1                         |                       |   |       |         |         |
| Sick Leave Fixed Income Investments      | 64.6                           |                       |   |       |         |         |
| Sick Leave Equity Securities             | 99.1                           |                       |   |       |         |         |
| Investments Purchased                    | 829.7                          |                       |   |       |         |         |
| Less:Interest and Dividends Receivable   | (33.5)                         |                       |   |       |         |         |
| Investments Sold                         | (712.8)                        |                       |   |       |         |         |
| Total Pension Fund Investments           |                                |                       |   |       |         |         |
| Net of Receivables                       | \$ 8,004.4                     |                       |   |       |         |         |

\*Rates of Return are annualized

<sup>1</sup> Includes Pareto Partners currency overlay account

\*\* Accounts open less than one year

<sup>^</sup> Includes performance from closed accounts

Prepared using a time-weighted rate of return in accordance with AIMR's Performance Presentation Standards.

(Concluded)



## Schedule of Investment Income for the Last Six Years

| <u>Year</u> | <u>Interest</u> | <u>Dividends</u> | <u>Gains &amp; Losses*</u> | <u>Total</u>  |
|-------------|-----------------|------------------|----------------------------|---------------|
| 1999        | 123,117,458     | 60,284,061       | 477,757,618                | 661,159,137   |
| 2000        | 153,008,941     | 71,583,903       | 629,687,058                | 854,279,902   |
| 2001        | 165,528,342     | 63,318,176       | (669,263,570)              | (440,417,052) |
| 2002        | 120,190,309     | 68,412,290       | (663,804,822)              | (475,202,223) |
| 2003        | 107,626,722     | 82,726,663       | 47,095,088                 | 237,448,473   |
| 2004        | 105,106,092     | 99,565,950       | 1,005,291,439              | 1,209,963,481 |

\*Includes realized and unrealized gains and losses and other investment income

## List of Largest Assets Held

### Largest Bond Holdings (by Market Value) June 30, 2004

|    | <u>Par</u>    | <u>Bonds</u>                     |                               | <u>Market Value</u> |
|----|---------------|----------------------------------|-------------------------------|---------------------|
| 1  | \$298,106,813 | U.S. TREASURY INFLATION INDEX NT | 4.250% 01/15/2010 DD 01/15/00 | \$341,192,489       |
| 2  | 240,902,649   | U.S. TREASURY INFLATION INDEX BD | 3.875% 04/15/2029 DD 04/15/98 | 307,188,458         |
| 3  | 17,685,968    | U.S. TREASURY INFLATION INDEX BD | 3.375% 04/15/2032 DD 10/15/01 | 21,522,992          |
| 4  | 19,920,000    | DEUTSCHE AUSGLEICHBANK EMT NOTES | 5.875% 05-FEB-2008 USD1000    | 21,224,760          |
| 5  | 18,700,000    | COMMIT TO PUR FNMA SF MTG        | 5.500% 08/01/2034 DD 08/01/04 | 18,542,209          |
| 6  | 17,100,000    | COMMIT TO PUR FHLMC GOLD SF MTG  | 5.000% 08/01/2034 DD 08/01/04 | 17,019,835          |
| 7  | 56,665,000    | GOVERNMENT OF POLAND             | 5.750% BDS 24-JUN-08 PLN1000  | 14,417,994          |
| 8  | 13,650,000    | U.S. TREASURY NOTES              | 4.750% 05/15/2014 DD 05/15/04 | 13,792,370          |
| 9  | 14,930,000    | INTER-AMERICAN DEVELOPMENT BANK  | 3.500% 08-JUL-2013 USD1000    | 13,683,793          |
| 10 | 12,263,341    | FHLMC POOL #C9-0767              | 6.000% 12/01/2023 DD 12/01/03 | 12,659,221          |

### Largest Stock Holdings (by Market Value) June 30, 2004

|    | <u>Shares</u> | <u>Stock</u>              | <u>Market Value</u> |
|----|---------------|---------------------------|---------------------|
| 1  | 2,022,262     | GENERAL ELECTRIC CO.      | \$ 65,521,289       |
| 2  | 1,800,071     | PFIZER, INC.              | 61,706,434          |
| 3  | 692,828       | AMERICAN INTL GROUP, INC. | 49,384,780          |
| 4  | 922,200       | WALMART STORES, INC.      | 48,655,272          |
| 5  | 1,688,420     | MICROSOFT CORP.           | 48,221,275          |
| 6  | 936,521       | CITIGROUP, INC.           | 43,548,227          |
| 7  | 969,498       | EXXON MOBIL CORP.         | 43,055,406          |
| 8  | 679,301       | WELLS FARGO & CO.         | 38,876,396          |
| 9  | 578,500       | CHELSEA PPTY GROUP, INC.  | 37,729,770          |
| 10 | 1,738,174     | GLAXOSMITHKLINE ORD       | 35,178,313          |

A complete list of portfolio holdings is available upon request.



## Schedules of Fees and Commissions for the Year Ended June 30, 2004

| <u>Investment Fees</u>                | <u>Average Assets<br/>Under Management</u> | <u>Fees</u>  | <u>Basis Points</u> |
|---------------------------------------|--|--------------|---------------------|
| Investment Manager Fees:              |  |              |                     |
| Equity Managers                       | \$5,055,543,848                            | \$13,622,849 | 27                  |
| Fixed Income Managers                 | 2,007,326,310                              | 1,424,912    | 7                   |
| Private Equity Managers               | 183,353,743                                | 5,168,590    | 282                 |
| Real Estate Managers                  | 277,652,544                                | 3,323,125    | 120                 |
| Total Investment Manager Fees         | \$7,523,876,445                            | 23,539,477   | 31                  |
| Other Investment Service Fees:        |  |              |                     |
| Custodian/Record Keeping Fees         |  | 3,882,111    |                     |
| Investment Consultant Fees            |  | 565,435      |                     |
| Legal Fees                            |  | 254,812      |                     |
| Actuary/Audit Service Fees            |  | 261,452      |                     |
| Total Investment Service Fees         |  | 4,963,810    | 7                   |
| Total Defined Benefit Plans Fees      |  | \$28,503,287 | 38                  |
| Total Defined Contribution Plans Fees |  | 203,628      |                     |
| Total Fees                            |  | \$28,706,915 |                     |

| <u>Broker Commissions</u>                        | <u>Base<br/>Commission</u> | <u>Total<br/>Shares</u> | <u>Commission<br/>per Share</u> |
|--|----------------------------|-------------------------|---------------------------------|
| Investment Technology Groups, New York           | \$ 832,631                 | 41,763,346              | 0.01994                         |
| Deutsche Banc Alex Brown, Inc, New York          | 593,469                    | 70,692,431              | 0.00840                         |
| Credit Lyonnais Securities Asia, Guernsey        | 247,712                    | 38,892,399              | 0.00637                         |
| Lehman Bros Intl, London                         | 237,112                    | 8,865,898               | 0.02674                         |
| Morgan Stanley & Co Intl, London                 | 187,486                    | 9,585,799               | 0.01956                         |
| Morgan Stanley & Co, Inc, New York               | 184,604                    | 98,003,650              | 0.00188                         |
| UBS Securities LLC, Stamford                     | 147,770                    | 5,534,931               | 0.02670                         |
| Lehman Bros, Inc, New York                       | 145,894                    | 5,803,600               | 0.02514                         |
| CSFB (Europe), London                            | 145,748                    | 20,968,552              | 0.00695                         |
| Goldman Sachs & Co, New York                     | 144,290                    | 71,978,976              | 0.01205                         |
| Merrill Lynch Pierce Fenner Smith, Inc, New York | 132,862                    | 4,729,407               | 0.02809                         |
| Merrill Lynch Intl, London                       | 111,537                    | 5,744,706               | 0.01942                         |
| Citation Group, New York                         | 108,773                    | 2,051,226               | 0.05303                         |
| Salomon Bros Intl Ltd, London                    | 103,480                    | 8,918,017               | 0.01160                         |
| Citigroup Gbl Mkts, Inc, New York                | 101,086                    | 2,310,099               | 0.04376                         |
| Merrill Lynch Pierce Fenner, Wilmington          | 94,869                     | 177,337,772             | 0.00053                         |
| Credit Suisse First Boston Corp, New York        | 90,097                     | 5,358,236               | 0.01681                         |
| Morgan J P Secs Inc, New York                    | 86,067                     | 24,060,488              | 0.00358                         |
| CSFB (HK) Limited, Hong Kong                     | 79,728                     | 4,714,187               | 0.01691                         |
| Deutsche Bk Ag (Intl Equities), London           | 75,044                     | 3,340,131               | 0.02247                         |
| UBS Warburg Asia Ltd, Hong Kong                  | 72,997                     | 16,121,395              | 0.00453                         |
| Citigroup Gbl Mkts/Salomon, New York             | 70,112                     | 29,572,758              | 0.00237                         |
| Banc of America Secs LLC, Charlotte              | 65,063                     | 1,597,860               | 0.04072                         |
| Jefferies & Co Inc, New York                     | 53,825                     | 1,150,000               | 0.04680                         |
| Other Brokers Under \$50,000                     | 1,686,139                  | 858,708,715             | 0.00196                         |
| Total Broker Commissions                         | \$5,798,396                | 1,457,804,579           | 0.00398                         |

A complete list of broker commissions is available from PERSI. PERSI does not require that investment managers use specific brokers.



## STATEMENT OF INVESTMENT POLICY AND GUIDELINES

### I. Introduction

The Board of the Public Employee Retirement System of Idaho (“the Board”)(“the System”) hereby establishes its Statement of Investment Policy for the investment of the trust funds (“the Trust”) in accord with Idaho Code Chapter 13, Title 59.

### II. Statutory Requirements

The investment of the Trust will be in accord with all applicable laws of the state of Idaho.

#### A. Sole Interest of Beneficiaries

Investments will be solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to the participants and their beneficiaries and defraying reasonable expenses of administration.

#### B. Prudent Investments

Investments will be made with the judgment and care under the circumstances then prevailing, which people of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable outcome as well as the probable safety of their capital. Investments will be diversified so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly prudent not to do so.

#### C. Fiduciary Duties

The Board and its agents, including staff, consultants, and investment managers, will discharge their duties with respect to the fund solely in the interest of the members and retired employees, and with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

### III. Investment Goals

#### A. General Objective

##### 1. Purpose

The purpose of the investment of Trust assets is to provide funds to meet the obligations of the Public Employee Retirement System of Idaho (PERSI) while incurring the appropriate amount of risk consistent with attaining that goal. The Board will invest the assets of the Trust so as to meet the projected obligations of the System, and will reduce risk through diversification of the assets of the Trust.

##### 2. Considerations

In determining the returns needed by the system, the acceptable risk levels, and the allowable investments, the Board will consider:

- \* the effect of particular investments on the total portfolio,
- \* the purpose of the plan,
- \* the diversification of the portfolio,
- \* liquidity needs and the current return relative to the anticipated cash flow requirements, and
- \* the projected return of the portfolio as it relates to the funding objectives of the plan.

#### B. Specific PERSI return and risk objectives

##### 1. Investment Returns

###### *(a) Actuarial Assumptions*

In projecting obligations and the returns needed to meet those obligations, the Board will consider studies performed by actuaries hired by the Board. The actuary uses an investment return assumption of 8% before fees and expenses in balancing projected obligations, projected contributions, and projected returns on assets. Assuming all of the actuarial assumptions are accurate, this 8% return will suffice to: (1) assure the payment of statutorily required benefits, which includes a 1% Cost of Living Adjustment (COLA); and (2) maintain the reduction of the level of the unfunded liability (if any) on the scheduled amortization (one year at a time). The assumed 8% return will not be sufficient to fund either discretionary COLAs (2-6%), retroactive COLAs, accelerate the amortization of the unfunded liability, build a stabilization reserve, or allow for gain-sharing distributions.



***(b) Inflation and Salary Assumptions***

This 8% rate assumes an inflation rate of 4.25% and an annual general state salary growth of 5.25%. To the extent that either inflation or salary growth are higher or lower than these rates, then the investment returns needed will also be higher or lower than the assumed 8%, although not on a 1:1 ratio. Consequently, the investment returns actually needed by the system do not have a nominal rate which can be determined with precision in advance -- the 8% rate currently used by the actuary is only a general midpoint accurate over long (15-20) year periods and is only as accurate as are the inflation and salary assumptions.

***(c) Relation to Funding Policy***

As set out in the Board's funding policy, to the extent investment markets allow, it is the desire of the Board to provide discretionary COLAs, accelerate the amortization of any unfunded liability, and provide for gain-sharing. It is also the goal of the Board to maintain a reasonable amortization of any unfunded liability, and not to exceed the 25 year amortization period set by statute. Therefore, it is the goal of the Board to set an expected rate of return above the actuarially assumed return so that (1) discretionary COLAs will have a reasonable chance of being consistently funded and (2) the scheduled amortization of any unfunded liability is not unreasonably jeopardized. Returns above that amount will be used to build a stabilization reserve and to distribute to the System participants through gain-sharing.

***(d) Periodic Specific Return Goals***

Because of the inflation sensitivity of both the returns needed by the system and the size of annual COLAs, an exact target return (either real or nominal) cannot be set in advance. Nonetheless, under most reasonable actuarial assumptions, PERSI has a relatively stable real return goal of between 4.75% - 5.25% if consistent funding of discretionary COLAs and providing for gain sharing is included as an objective. Consequently, specific return goals for upcoming periods will be set out in the strategic asset allocations periodically adopted by the Board.

**2. Investment Risk and Strategic Asset Allocations**

***(a) Diversification Among Asset Classes***

In controlling the risk level that is appropriate for the Trust, the Board will diversify the assets of the Trust among various asset classes as the Board may from time to time adopt as appropriate asset classes. The specific asset classes to be used will be set in conjunction with the strategic asset allocation adopted from time to time by the Board.

***(b) Review of Asset Classes and Asset Allocation***

In setting strategic allocations, the Board will focus on assuring that the expected long-term returns will meet expected long-term obligations with the appropriate level of risk sufficient to meet those objectives. The Board will at least once every four years determine the appropriate asset classes for the investment of Trust assets and conduct asset allocation studies to help determine the long term strategic allocations among desired asset classes so as to meet long-term return objectives with the appropriate level of risk.

***(c) Content of Strategic Asset Allocations***

The strategic asset allocation will set out the asset classes to be used, the long-term strategic "normal" percentage of assets to be invested in each asset class, the short to intermediate term ranges that will be considered allowable temporary deviations from the strategic normal allocation, the investment risk and return expectations for each asset class, the numerical investment return and risk expected to be realized, and the relation of the expected investment return to the real and actuarially assumed investment return.

***(d) Strategic Policies***

In addition to asset allocation, the Board may from time to time adopt strategic policies. "Strategic policies" are actions by the Board to invest in asset types that have not been singled out as "asset classes" in the asset allocation process, to overweight particular sectors within an asset class, or to employ particular strategies in the investment of Trust assets. The purposes of these actions are either to increase the return above the expected return or to reduce risk. Examples of types of strategic policies include: a tilt towards small capitalization stocks in U.S. equity allocations; a tilt toward mortgage exposures in fixed income; hedging international currency exposures through a currency overlay program, and adding international emerging markets exposure in international equities.

**IV. Investment Structure**

**A. Overall Structure**

In making individual investment policy decisions, the Board will have as an overall goal a flexible, simplified structure with clear roles and accountability.



## **1. Board Ultimately Responsible**

The Board is ultimately responsible for all investment activities. In exercising this responsibility, the Board will hire investment personnel and agents and delegate various investment functions to those personnel and agents. Where the Board does not delegate investment powers or duties, the Board will either satisfy itself that it is familiar with such matters, or will retain persons who are familiar with such matters to consult or assist the Board in the exercise of those responsibilities. Where the Board delegates a responsibility, it will be delegated to a person who is familiar with such matters, and the Board will monitor and review the actions of those to whom responsibilities are delegated.

## **2. General Roles and Responsibilities of Board and Agents**

The Board will favor a structure that accommodates a citizen Board and a small staff. The Board and staff will concentrate their activities on:

- \* strategic decisions, primarily concerning asset allocation and strategic policies;
- \* adjusting the mix between passive and active managers depending on, among other considerations, near-term concerns regarding the U.S. and other capital markets; and
- \* delegating and monitoring all other activities, including hiring and monitoring investment managers.

The Board will rely on outside agents, and primarily investment managers, to be responsible for non-strategic decisions. This responsibility includes those investment decisions with shorter-term consequences such as the best near-term securities, regions, asset types, or asset classes.

### **B. Direct (Non-Delegated) Responsibilities of the Board**

#### **1. Specific Responsibilities**

The Board will be directly responsible for

- \* Setting investment policy,
- \* Determining the investment structure of the Trust,
- \* Determining the asset classes to be utilized,
- \* Setting the strategic asset allocation,
- \* Determining strategic policies;
- \* Hiring agents to implement the strategic asset allocation;
- \* Hiring agents to implement strategic policies; and
- \* Monitoring the compliance of those agents with the investment policies and strategic allocations set by the Board.

#### **2. Delegation and Monitoring of Specific Investment Activities**

The Board will normally delegate investment decisions concerning specific securities or assets, or the tactical allocations of assets among asset types, to outside agents. The Board will retain direct responsibility for the monitoring of the activities of those agents through periodic reports from its staff or consultants. The Board may choose to exercise direct investment responsibility if unusual market conditions or other circumstances so indicate.

### **C. Employees, Consultants, and Advisors to the Board**

#### **1. Investment Staff**

##### ***(a) Duties of Chief Investment Officer and Other Staff***

The Board will hire a Chief Investment Officer and such other staff as it considers appropriate who will be generally responsible for the oversight of the investment of Trust assets, and, as part of that overall responsibility, will: (1) supervise, monitor, and evaluate the performance of the investment managers hired by the Board to assure compliance with investment policy and individual guidelines; (2) assist the Board in developing and adjusting investment policy, including reviewing and modifying the asset allocation as conditions warrant; (3) research current market conditions, evaluate new products, and seek out new approaches to improve portfolio return, reduce risk, and reduce costs and fees; (4) work with the consultants, custodians, investment managers, and other agents in the performance of their assigned duties; and (5) assist the Board with education and other efforts to promote good decision making. Except in special circumstances, PERSI staff will not be responsible for the investment, purchase, or sale of specific assets.

##### ***(b) Allocation of New Net Contributions***

The Chief Investment Officer shall allocate new net contributions to or withdraw net distributions from the system among investment managers in accordance with the strategic and tactical ranges established by the Board in the strategic asset allocation. The Chief Investment Officer shall report to the Board regularly on the allocation of new net contributions or the withdrawal of net distributions.



***(c) Tactical Asset Allocation***

With prior notice to the Board, the Chief Investment Officer may shift assets among managers (including between passive and active managers) as long as the asset allocation is maintained within the strategic ranges. If conditions do not permit giving prior Board notice, the Chief Investment Officer is authorized to move assets among investment managers within the strategic ranges established by the Board. If such action is taken, the Chief Investment Officer shall notify the Chairman of the Board as soon as is practical either that action is contemplated or has been taken, as circumstances warrant.

***(d) Minimum Qualifications of Chief Investment Officer***

The Chief Investment Officer shall at least: (a) have a graduate degree in finance, law, business administration, or a related field, or (b) be a Chartered Financial Analyst; or (c) have three or more years experience in the investment of trust assets.

**2. Actuaries**

The Board will hire an actuary to provide studies that will: (1) determine the long term obligations faced by the System through annual actuarial valuations, (2) set out return objectives or assumptions that will be sufficient to meet those obligations; and (3) provide reviews at least once every four years of the actuarial valuation process, including updating the projections and assumptions in light of the experience of the System. The Board will set its long-term return objectives after considering information provided by those studies.

**3. Investment Consultants**

The Board will hire a qualified independent consultant, whose relationship does not impose a conflict of interest with the Board or staff, to provide investment performance measurement at least quarterly with the report available to the Board within three months of the quarter end. The report will at least compare actual investment returns of the system -- in total, by each asset class, and for each managed portfolio -- with both the investment objectives of the system and a composite of returns of other institutional investors. The Board may hire other independent investment consultants as needed to assist the Board in the management of its investment activities, including, but not limited to: (1) performing asset allocation studies, and reviewing and recommending modifications of the asset allocation as conditions warrant; (2) assisting in monitoring the investment managers to assure they are in compliance with the investment policy and their individual guidelines; (3) performing manager evaluations and searches as may be necessary; and (4) assisting in the development and adjustment of investment policy. Except for consultants retained solely for purposes of performance measurement, consultants will be fiduciaries of the Trust.

**D. Managers or Agents with Delegated Responsibilities**

**1. Custodian**

***(a) Responsibilities***

The Board will hire custodians and other agents who will be fiduciaries of the Trust and who will assume full responsibility for the safekeeping and accounting of all assets held on behalf of the Trust. Among other duties as may be agreed to, the custodian will be responsible for: (a) the receipt, delivery, and safekeeping of securities; (b) the transfer, exchange, or redelivery of securities; (c) the claiming, receipt, and deposit of all dividend, interest, and other corporate actions due the Trust; (d) the daily sweep of all uninvested funds into a cash management account or accounts; and, (e) the provision of reports to PERSI upon agreed time intervals that will include all purchases and sales of securities, all dividend declarations on securities held by the Trust, a list of securities held by the Trust, and a cash statement of all transactions for the Trust account.

***(b) Authorization of Collective Investment Trusts***

Assets of the Trust may be invested in any collective investment trust, which at the time of the investment provides for the pooling of the assets of plans described in Section 401(a) of the Internal Revenue Code of 1986, as amended, and which is exempt from Federal income tax. Assets of the Trust may be commingled with assets of other trusts if invested in any collective investment trust authorized by this policy. The provisions of the trust agreement, as amended by the trustee thereof from time to time, of each collective investment trust in which Trust assets are invested are by this reference incorporated as a part of the trust estate comprising the Trust. The provisions of the collective investment trust will govern any investment of Trust assets in that trust.

**2. Investment Managers**

The Board will hire investment managers who will be fiduciaries of the Trust and who will be responsible for the investment of Trust assets in specific securities or assets within or among the asset classes.

***(a) Minimum Qualifications***

Investment managers shall be registered with the Securities and Exchange Commission (unless they are banks, insurance companies, or other category exempted from such registration requirements), have been in the business of investment management at least two years



(or the main personnel of the investment management firm have worked together in the business of investment management for at least two years), and, usually, have other United States pension fund assets under management.

***(b) Guidelines***

Investment Managers shall manage assets in accordance with additional guidelines established by contract and as may be added to or modified from time to time. The additional guidelines will contain minimum diversification requirements that must be followed by that manager. These guidelines will also set out the investment return expected to be achieved by that manager, and shall be linked to a benchmark that represents the passive index fund that would be used to replicate the manager's assignment.

***(c) Responsibilities and Discretion***

Subject to the restrictions set out in this policy or as may be set out in individual contracts or guidelines, an investment manager shall have full discretionary power to direct the investment, exchange, and liquidation of the assets entrusted to that manager. The manager shall place orders to buy and sell securities and, by notice to the custodian, cause the custodian to deliver and receive securities on behalf of the Trust.

***(d) Corporate Governance***

The Board, unless otherwise stated, will delegate the voting of proxies to the investment manager or custodian. The Board will adopt and from time to time modify a proxy voting policy. The staff will review the investment manager's policies governing the voting of proxies to assure consistency both with the policy of the Board and, to the extent feasible, among the various investment managers.

***(e) Transactions and Brokerage***

All securities transactions shall be executed by reputable broker/dealers or banks, and shall be on a best price and best execution basis.

**3. Use of Passive and Active Managers**

***(a) Purpose and Use of Active Management***

The Board recognizes that passive (index fund) investing has lower costs than active investing, with regard to both management fees and transaction costs. Further, the Board also recognizes that there is uncertainty concerning whether active investing can generally outperform passive investing, particularly in the large, liquid, and efficient portions of the capital markets. Also, the Board has great confidence that a passive investment of assets in an efficient asset allocation will likely meet long-term (20 year) obligations.

Contribution rates, COLAs, and the ability to provide for gain-sharing, however, are based on 1-5 year returns. The Board does have concern that over 1-5 year periods the ability consistently to fund COLAs and to keep contribution rates stable are in considerable jeopardy from two sources: (1) expected "normal" market fluctuations are such that annual returns will likely not meet hurdle rates approximately 40% of the time, with actual negative returns to be expected once every six years; and (2) that most of Trust assets under the strategic asset allocation will be invested in U.S. capital markets, and are thus vulnerable to poor U.S. returns.

One purpose of active management of Trust assets is to address these two concerns. Active managers will be hired for the purpose of providing greater stability of returns, and better returns, than would be achievable under purely passive management over rolling 3-5 year periods. Active managers will be responsible for timing of markets and the tactical allocation of assets among and within the capital markets (including between the U.S. and international markets).

In addition to providing extra returns, active managers will also be employed to smooth returns, provide higher long-term returns, provide protection in adverse markets, and to add exposure and additional diversification to the portfolio than that achievable solely through investment in passive indices representing the strategic asset allocation and strategic policies.

***(b) Structure***

In using outside managers, the Board will favor a structure using a reasonable number of managers with broad mandates and benchmarks. This preference will be implemented so as to achieve the following goals: to relieve the Board from making timing decisions in allocating assets among numerous specialized managers, to simplify the structure of the fund, and to reduce the number of active managers and thus expenses to the Trust.

Passive managers will be favored for the core, liquid, efficient markets (such as S&P 500 stocks and U.S. Government/Corporate bonds), and active managers will be favored for relatively inefficient markets (such as international emerging markets). Global managers will be used to provide flexibility in reacting to near-term concerns that may arise concerning any particular region or market, particularly the U.S. capital markets, and to provide an appropriate balance between efficient long-term asset allocations (which favor US assets) and near-term allocations (which have a greater preference for international assets) to meet the real (inflation adjusted) return needs of the System. Consequently, actual allocations to international equities in the overall portfolio from time to time may be above that in the strategic asset



allocation due to the activities of the global equity managers. The actual exposure to international equities will be maintained within the strategic range unless there is prior review by the Board before those ranges are exceeded.

***(c) Balance between Passive and Active Management***

The balance between active and passive management will be set from time to time with the following considerations in mind: concentration of active investment efforts where there is the most potential for excess returns, implementation of views concerning the state of the U.S. and international capital markets, and reduction of fees and other costs.

***(d) Monitoring Standards***

Active managers will be monitored under two standards: First, over rolling 3-5 year periods managers will be expected to exceed, after fees, the benchmark index that represents the passive alternative to the mandate given the manager, and to rank in the top half of the universe of managers that best fits that manager's mandate. Second, over shorter periods of time, managers will be expected to maintain key personnel, a consistent style, and investment capability. Passive managers will be monitored on their ability to track their benchmark index over both short (1 quarter to one year) and long periods (3 to 5 year). The Board may consider other information it considers relevant, including composite manager indices, in determining whether to retain or terminate managers.

**V. Asset Class Policies**

**A. U.S. Equities**

**1. Objective**

The overall objective of the U.S. equity asset class is to obtain, over time, a return after fees that equals or exceeds the returns of the Russell 3000 Index, both absolutely and on a risk-adjusted basis.

**2. Allowable Investments**

Managers may invest in stocks that do not pay dividends. Managers may invest in equity securities outside of the Russell 3000 Index. Managers may use derivative securities for purposes of enhancing liquidity, reducing transaction or other costs, or partially hedging an existing exposure in the portfolio.

**3. Manager Styles**

Managers for this asset class may include index funds, style managers (such as value and growth), "core" managers, and global managers. Global managers are managers who may invest in securities located anywhere in the world, both within and outside of the United States.

**4. Benchmarks**

The Russell 3000 index will be the benchmark for the passive index funds, core managers, and global managers. Other style or capitalization indices maintained by a qualified organization may be used as the benchmark for style managers. Active U.S. equity managers are expected to exceed, over rolling 3-5 year intervals, the applicable benchmark by 75 basis points annually after fees, and to rank in the top 50<sup>th</sup> percentile of active managers with similar mandates.

**B. International Equities**

**1. Objective**

The overall objective of the International Equity Asset Class is to obtain, over time, a return after fees that equals or exceeds the returns of the Morgan Stanley Capital International Europe, Australia, and Far East (MSCI EAFE) Index (unhedged), or the FT Actuaries World ex U.S. Index, both absolutely and on a risk-adjusted basis.

**2. Allowable Investments**

Managers may invest in stocks that do not pay dividends. Managers may invest in American Depositary Receipts or American Depositary Shares. Managers may invest in equity securities of companies or in countries that are not included in the indices. Managers may use derivative securities for purposes of enhancing liquidity, reducing transaction or other costs, or partially hedging an existing exposure in the portfolio. Managers may, at their discretion, hedge the currency exposure of all or part of their portfolios. Managers may not overhedge their portfolio, although proxy hedging for purposes of liquidity and cost savings is allowed.

**3. Manager Styles**

Managers for this asset class may include index funds, general international managers, regional or specialized managers (such as emerging markets), and global managers. The Board may from time to time hire a currency overlay manager to hedge the currency exposure in those portfolios where managers do not actively or normally consider hedging their exposure.



#### **4. Benchmarks**

The MSCI EAFE Index (unhedged), or the FT Actuaries World ex U.S. (unhedged) will be the benchmark for the passive index funds, general international managers, and global managers. Regional or specialized indices (unhedged) maintained by a qualified organization may be used as the benchmark for other active managers. Active international equity managers are expected to exceed, over rolling 3-5 year intervals, the applicable benchmark by 75 basis points annually after fees, and to rank in the top 50<sup>th</sup> percentile of active managers with similar mandates.

### **C. Fixed Income**

#### **1. Objectives**

The overall objective of the Fixed Income Asset Class is to obtain, over time, a return after fees that equals or exceeds the returns of the Lehman Brothers Aggregate Bond Index (Aggregate Bond Index) both absolutely and on a risk-adjusted basis.

The Fixed Income Asset Class shall consist of investments in mortgages and in both dollar and non-dollar fixed income securities. Mortgages shall consist of investments in mortgage backed securities, and direct ownership of commercial mortgages through the Idaho Commercial Mortgage Program.

The objective of the non-mortgage fixed income securities is to obtain, over time, a return after fees that equals or exceeds the returns of the Lehman Brothers Government/Credit Bond Index (Government/Credit Bond Index) on a risk-adjusted basis. The overall objective of the mortgage securities is to obtain, over time, a return after fees that equals or exceeds the returns of the Lehman Brothers Mortgage Index (Mortgage Index) on a risk-adjusted basis.

#### **2. Allowable Investments**

Managers may invest in debt securities that do not pay interest. Active managers may invest in securities in companies or countries not included in the indices. Managers may use derivative securities for purposes of enhancing liquidity, reducing transaction or other costs, or partially hedging an existing exposure in the portfolio. Fixed income managers may, at their discretion and to the extent allowed by their contracts and guidelines, use currency forward or futures markets as may be considered appropriate to implement fixed income strategies.

#### **3. Manager Styles**

Managers in this asset class may include index funds, domestic bond managers, specialized managers, and global managers.

#### **4. Benchmarks**

The Government/Corporate Index or Aggregate Index will be the benchmark for all non-mortgage fixed income managers. The Mortgage Index will be the benchmark for all mortgage managers. The Aggregate Index will be the benchmark for the asset class. Active fixed income managers are expected to exceed, over rolling 3-5 year intervals, the applicable benchmark by 25 basis points annually after fees, and to rank in the top 50<sup>th</sup> percentile of active managers with similar mandates.

### **D. Real Estate**

#### **1. Objectives**

Private equity real estate investments will be considered part of the U.S. Equity asset class. The overall objective of private equity real estate investments is to attain a 6% real rate of return overall, over a long-term holding period, as long as this objective is consistent with maintaining the safety of principal. The 6% real rate of return includes both income and appreciation, is net of investment management fees, and is net of inflation as is measured annually by the Consumer Price Index. Over a short term basis, the objective is to earn a nominal minimum income yield of 6% on each individual investment, or inflation plus 3%, whichever is greater.

#### **2. Allowable Investments**

Allowable private equity real estate investments will include open-end and closed-end commingled real estate funds, publicly traded real estate investment trusts, and direct real estate investments originated by selected real estate advisors who structure similar investments with other institutional investors. The real estate asset sector will not include solely debt obligations; in particular, straight mortgage interests will be considered part of the fixed income asset class.

#### **3. Need for Income Component of Return**

Upon acquisition, each real estate investment must have as a goal the expectation of production of annual income measured by realized return and not capital appreciation. Thus, a significant proportion of income producing properties and not purely development properties should be the objective of any commingled fund acquired.



#### 4. Protection of the Trust

Investment vehicles should be chosen that will protect the Trust, including provision for investments that do not contain debt or liability with recourse beyond the Trust commitment to the related business entity, provision for inspection and evaluation of environmental hazards prior to the purchase of any property, and the provision of insurance coverage to protect against environmental and natural hazards.

#### 5. Reporting

A comprehensive reporting system for individual investments or funds will be maintained so that poorly performing investments and deficiencies in portfolio diversification can be identified and active portfolio management facilitated. Investment managers shall be required to present opinions of fair market value as part of quarterly and annual reporting requirements, and audited financial statements shall be required at least annually for each investment entity.

### E. Alternative Investments

#### 1. Definition and Board Approval

The Board may from time to time authorize the investment of Trust assets in entities or structures that do not fit the asset descriptions listed above. Examples of such investments are venture capital partnerships, private equity, leveraged buy-out funds, private debt, and direct ownership of individual assets such as oil and gas partnerships. These investments shall only be entered into with the specific approval by the Board or a subcommittee given specific delegation by the Board of each investment vehicle, or investment manager.

#### 2. Objectives and Benchmarks

If the alternative investment is an equity investment, the objective for the investment will be to exceed, over time and after fees, the return achieved by the Russell 2000 Index times 1.35. If the alternative investment is a debt investment, then the objective will be to exceed, over time and after fees, the returns achieved by the Lehman Brothers Government/Credit Index plus 3%. It is recognized that these investments will experience greater volatility than the comparable publicly traded securities and indices.

#### 3. Asset Allocation

For purposes of asset allocation, alternative equity investments will be treated as part of the U.S. equity asset class, and alternative debt investments will be treated as part of the fixed income asset class.

### STRATEGIC ASSET ALLOCATION

| Asset Class          | Expected Return | Expected Risk | Strategic Normal | Strategic Ranges | Actual Allocation<br>Year Ended<br>June 30, 2004 |
|----------------------|-----------------|---------------|------------------|------------------|--|
| U.S. Equity          | 10.4%           | 19%           | 54%              | 44% - 57%        | 57%  |
| International Equity | 11.0%           | 22%           | 15%              | 12% - 25%        | 15%  |
| Total Equities       |                 |               | 69%              | 66% - 75%        | 72%  |
| Fixed Income         | 6.6%            | 7%            | 30%              | 27% - 33%        | 28%  |
| Cash                 | 4.0%            | 1%            | 1%               | 0% - 5%          | 0%   |

| Total Fund | Expected Return | Expected Inflation | Expected Real Return | Expected Risk |
|------------|-----------------|--------------------|----------------------|---------------|
| Actuary    | 8.00%           | 4.25%              | 3.75%                | n/a           |
| Portfolio  | 9.30%           | 3.75%              | 5.55%                | 13.50%        |